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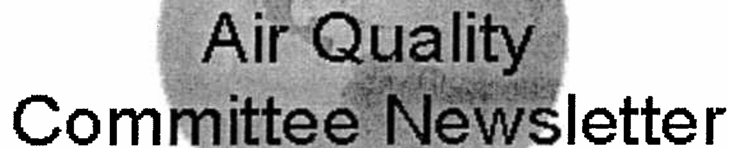

Air Quality Committee Newsletter

Vol. 9, No. 1 November 2005

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Kathryn B. Thomson, Editor

In this issue:

Message from the Chair
Matthew Tanzer 1

Membership Update
Angela R. Morrison 3

Newsletter Report
Kathryn B. Thomson.......................... 3

The "Carbon Cartel" or Wise Capitalists: What is Going on with Voluntary Greenhouse Gas Reductions
Andrew J. Hoffman 3

Regional Reports:
Region 2 7
Region 3 8
Region 5 (Federal Developments)... 16
Region 5 (State Developments) 17
Region 6 18
Region 9 20
EPA Headquarters.......................... 22

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Section of Environment, Energy and Resources

THE "CARBON CARTEL" OR WISE CAPITALISTS: WHAT IS GOING ON WITH VOLUNTARY GREENHOUSE GAS REDUCTIONS?

Andrew J. Hoffman
The University of Michigan
Ann Arbor, Michigan

The United States government has announced that it will not ratify the Kyoto Protocol on greenhouse gas (GHG) emissions. Yet, many companies have chosen to initiate voluntary reductions anyway, often in concert with programs established by industry associations (such as the Business Roundtable), non-profit organizations (such as Environmental Defense, WRI, NRDC and the Pew Center on Global Climate Change) and the federal government (such as the Climate Leaders Program). To date, as many as 60 corporations, with net revenues of roughly $1.5 trillion, have set reduction targets and hundreds more are considering such steps. *What is going on here? Why are they doing this?*

Some have criticized this group of companies, dubbing them the "carbon cartel" or the "Kyoto capitalists" and charging that they are unscrupulously seeking financial gain from the climate change issue. Writes one detractor, these companies are embracing a "cynical approach to regulation"; an effort to reap financial benefits while the "costs can be foisted on the backs of others." This complaint seems rather strange, particularly when it comes from within business circles.

Scanning the business horizon for opportunities to protect assets and improve the bottom line is precisely what companies are expected to do. Their shareholders demand no less. Since regulation is part of the business environment, any company that can foresee business opportunities in, say, the Clean Air Act, the Clean Water Act, the Montreal Protocol and climate change is practicing what is expected of business managers—capitalism!

And capitalism is exactly what is happening. In point of fact, many within the business community dislike the Kyoto Protocol, viewing it as a suboptimal mechanism for bringing about a business solution to this problem. But it is also true that the lack of U.S. participation in Kyoto has created what the business community dislikes even more—uncertainty. Will there be mandatory reductions in GHG emissions in the future? The answer to this question is unclear. And when faced with such a lack of clarity, companies must plan for multiple scenarios, a costly but necessary endeavor in any arena.

Today, many of the companies that are acting preemptively on GHG reductions are agnostic about the science of climate change or the social responsibility of protecting the global climate. The reasons that they have for making these reductions are decidedly strategic. They are searching for ways to be prepared for the long term should GHG emission reductions become mandatory, while at the same time attempting to reap near term economic and strategic benefits should that future not emerge or be delayed. At a time when industry groups are beginning to acknowledge the economic import of climate change—notably, the Conference Board warned that "businesses that ignore the debate over climate change do so at their peril"—many forward thinking companies have decided that it is in their best interests to hedge their strategic bets, preparing for either scenario. This is just smart business.

From a business viewpoint, controls on GHG emissions are not just an environmental issue driven by regulatory or social pressures, but a strategic issue driven by market pressures. GHG controls represent a market transition, one not unlike those that have occurred in the past where consumer needs change or technology advances. In such circumstances, companies face new competitive environments where some decline and others rise to fill their place. The typewriter industry was virtually eliminated by the computer in the early 1980s; the compact disc replaced the phonograph album in the mid-1980s; the 1984 dissolution of the Bell System wrought structural changes in the telecommunications industry.

Climate change will present such a transition. But unlike these other market shifts, climate change represents a transition of a fairly new and unusual kind. In regions where Kyoto is ratified, it amounts to the establishment of a new world-wide market in pollution, pollution credits, capital and emissions abatement technology. So, companies that are adept at
(a) reducing their GHG emissions by altering products and processes or perhaps sequestering carbon;
(b) trading in emission credits so as to capitalize on this new commodity market; (c) accurately incorporating climate risk into financial decision-making models; or
(d) marketing new management skills or technologies that produce less greenhouse gases, will find advantage in the emerging climate change market transition. And in regions where Kyoto remains unratified, companies may still find themselves in an altered landscape, as local or state governments adopt mandatory controls or their divisions, competitors, suppliers, buyers, consumers and investors either operate in ratified regions or see a proactive stance in GHG reductions as wise business strategy.

In either case, the key to financially successful emissions reductions requires an assessment of a company's strategic positioning vis- -vis GHG emissions. And to do this, companies must ask new kinds of questions and undertake new kinds of analyses. Table 1 offers a list of such question—questions that are unfamiliar to most corporations. As a result, many companies simply do not know their potential exposure and strategic positioning on this issue.

The answers to these questions will determine a company's exposure to GHG controls. And in these answers lie great opportunities and grave implications.

Operational Improvement
What is the energy efficiency of your operations, and can you improve it?
Do you know how to measure your company's production of carbon dioxide and other greenhouse gases (methane, nitrous oxide, hydrofluorocarbons, perfluorcarbons, and sulfur hexafluoride)?
Do you know the available technologies or alternatives for reducing emissions and the cost/benefit trade-offs associated with each?

Anticipating and Influencing Climate Change Regulations
Do you know how to monitor and forecast the development of GHG regulations at the state, federal and international levels?
Can you influence the form of those regulations?

Accessing New Sources of Capital
Do you know how to conduct commodity trading of GHG emissions?
Are you aware of government subsidies for efforts to reduce GHG emissions?

Improving Risk Management
Are any of your operations at risk due to the natural consequences of climate change and do you know the financial implications of that exposure?
Do you know how to quantify your emissions and the financial liabilities they may incur should a GHG disclosure scheme go into force?

Elevating Corporate Reputation
How is your company's market reputation improved or harmed by its posture towards GHG reductions?
Do you have good relations with key constituencies that care about that posture?

Identifying New Market Opportunities
Are there alternative product or process lines that you could be exploring that will become more attractive as GHG reduction programs proliferate?
Are there products or services (including GHG credits) that your company can sell to other companies who have decided to embark on voluntary GHG reduction programs?

Enhancing Human Resource Management
Are your employees concerned about GHG emissions?
Would voluntary reduction initiatives improve morale, increase the retention rates of skilled workers, lower the costs of recruiting and training new ones, or attract and retain higher caliber applicants?

Table 1: Questions for Exploring the Strategic Dimensions of Voluntary Greenhouse Gas Reductions. (This table is from: Hoffman, A. (2005) "Climate change strategy: The business logic behind voluntary greenhouse gas reductions," *California Management Review*, Volume 47, Number 3, Spring.)

There will be winners and losers; those with an interest in resisting and trying to delay such a market transformation, and those who will try to capitalize on it. The difference between these two groups lies in a careful cost/benefit analysis of doing something versus doing nothing. The benefit from voluntary GHG reduction programs must be based on sound business logic. They must have a bottom line rationale or such efforts will be financially unsustainable. The "carbon cartel" has merely taken steps to assess this bottom line rationale and position themselves to minimize risk or maximize potential gain. And thus, their efforts pit them against those companies that do not face similarly advantaged positions, or do not believe they do.

An important factor to consider in assessing this bottom line analysis is that the market implications of GHG reductions are still fluid in their full import. The actual form of the market transition over climate change has yet to be realized, and the opportunities and risks of action versus inaction are not yet clear. They will be determined by the rules of GHG mitigation and trading that get established. For example, how will reduction targets be allocated under a climate change treaty? Will they be based on the magnitude of GHG emissions, or on a normalized GHG intensity measure such as CO_2 per BTU, or CO_2 per dollar of shipments? Will they be based on the fuel mix or will there be some other measure? And beyond the exact measure, will suppliers be solely responsible for GHG reductions or will consumers share the load? These questions will have direct bearing on who will win and who will lose in a climate change market transition.

But meanwhile, as these questions get played out in the future, companies must still decide what to do today. As we scan the business environment, we can begin to speculate on specific contextual circumstances that may determine who may benefit from voluntary GHG reductions. For example, companies contemplating operational changes now may be more inclined to incorporate GHG reductions in their decision-making than companies with a great deal of existing operating assets, particularly if those assets are relatively new and have many years of operating life remaining. Each year, U.S. industry spends more than $700 billion on new plants and equipment. Managers must evaluate the investment profitability based on an expected useful lifespan.

For new facilities, should a company include greenhouse gas reduction technologies in the initial design or take a chance on leaving them out with the anticipated contingency of retrofitting or buying credits later? If the decision is to install new technologies, should they choose technologies that go beyond any anticipated emission standards and allow the company to create a surplus of permits for sale or use elsewhere in the company? These are important and difficult questions, the answers to which must be based on regulatory forecasting and an economic analysis of the cost and benefits should Kyoto, or some Kyoto-type objectives, come into force.

Companies that are heavy emitters may see a benefit in resisting GHG reductions so that they will not have to buy pollution permits or invest in new technology. But looking more deeply, a more important question may be whether the company is near the limits of efficiency in its operations. In reality, it is the most energy and carbon inefficient companies that have the most potential for environmental and economic gain (depending on the price of permits and the cost of reductions). In the end, the entrepreneurial question in GHG reductions is how can one generate carbon reductions or credits at the lowest cost and sell them at the highest price? And then, how does this cost/revenue equation match up against their competitors? Or to put it more succinctly, can your company be advantaged or will your competitor be disadvantaged by GHG reductions?

Utilities that can recover costs of operational changes may be more likely to adopt GHG reduction programs than those that cannot, as the uncertainty of the return on investment is minimized. Those that are more heavily invested in natural gas may be more inclined than those heavily invested in coal. (Those companies that are more invested in nuclear or renewable energy sources will also be more likely to support mandatory GHG controls as they will raise the costs for their fossil-fuel burning competitors.) Companies that exist in mature markets with little opportunity for process or

product substitutes may be more likely to resist GHG reductions than those in evolving markets where alternatives are available for achieving reduction goals. And, those companies that supply industry sectors that embrace GHG reductions may hold a more favorable view of GHG reductions than those that service the more resistant fields. These are just a few variables by which winners and losers may be decided.

In the end, the business question over climate change is the same as the business question that has been asked in regards to other environmental issues—does it "pay to be green"? And, as we are realizing in other environmental issues, this question needs to be refined. It is too simple in its presentation. It is synonymous with asking whether it "pays to innovate." The question makes no sense. The correct question asks whether there exists an economic opportunity for *your company* to be green vis- -vis your competitors, and then asks *how* and *when* that opportunity can best be achieved. As such, the decision to make voluntary GHG reductions is a strategic issue based on an individual company's competitive assets, market position and organizational abilities.

Professor Hoffman holds joint appointments at the Stephen M. Ross School of Business and the School of Natural Resources & Environment at the University of Michigan. He can be reached at (734) 763-9455 or ajhoff@umich.edu. *This paper was supported by Environmental Defense and the Frederick A. and Barbara M. Erb Institute for Global Sustainable Enterprise at the University of Michigan.*

Like to Write? Like to Edit?

The Air Quality Committee welcomes the participation of members who are interested in preparing this newsletter. If you would like to lend a hand by writing, editing, identifying authors, or identifying issues please contact the editor-in-chief, Kathryn B. Thomson, at kthomson@sidley.com.